

FREDDIE MAC: ACCOUNTING STANDARDS ISSUES RAISED IN THE DOTY REPORT

HEARING BEFORE THE SUBCOMMITTEE ON COMMERCE, TRADE, AND CONSUMER PROTECTION OF THE COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTH CONGRESS FIRST SESSION

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THURSDAY, SEPTEMBER 25, 2003

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Shimkus, Shadegg, Radanovich, Bass, Bono, Terry, Otter, Schakowsky, Green, McCarthy, Strickland, and DeGette.

Staff present: David Cavicke, majority counsel; Ramsen Betfarhad, majority counsel, Will Carty, legislative clerk; and Consuela Washington, minority counsel.

Mr. STEARNS. Good morning everybody, and welcome to the Subcommittee on Commerce, Trade, and Consumer Protection of the Committee on Energy and Commerce. Today we have a very important hearing. The first opportunity for Congress to hear the results of an internal investigation at Freddie Mac regarding accounting problems there. We are privileged to have Mr. Doty, partner at Baker Botts who was in charge of this investigation that produced this internal report.

I have had the opportunity to review the report and wish to compliment him on its thoroughness, rigor and objectivity. Members on the Energy and Commerce Committee have had an opportunity in recent years to examine a number of reports on internal investigations. The Doty report, in my view, is at the top of those reports in its completeness and its ability to explain very complicated transactions. Also accompanying Mr. Doty is Mr. James Barratt, who led a team of forensic accountants who reviewed Freddie Mac's books. I also commend you for your work, and I hope Mr. Doty will have the opportunity to identify the members of his team who I understand are accompanying him in this hearing.

Finally we have Professor Baruch Lev. Professor Lev has provided expert testimony to the Congress a number of times on very complicated accounting matters. So we appreciate his help today. I also would like to compliment Freddie Mac. They had cooperated with our inquiry and provided to the committee information and documents so we can have a better understanding about these issues. There are two things for us to consider today, the first is

the report itself obviously and the second is what is permissible under GAAP.

Although Freddie Mac, by its own admission, made serious accounting misstatements, had they structured some of these transactions differently, it is possible that GAAP would have permitted the nondisclosure of the fair value of Freddie Mac's derivative portfolio. For the benefit of taxpayers who implicitly guarantee Freddie's portfolio and investors, we need to ask if GAAP is adequate if it allows a company with \$600 billion in mortgages and \$1 trillion in derivatives not to have fair value disclosure of the bulk of these assets. The report made a number of findings of great significance that we should consider.

Beginning in December, 2000, senior management of Freddie Mac engaged in multiple complex transactions in order to hide the increase in value in its derivatives portfolio. There was no economic purpose to these transactions other than to simply hide income. Freddie Mac incurred expenditures to hide income for accounting purposes. These transactions included the so-called Giant. This transaction involved shifting \$30 billion of Freddie Mac securities in which Freddie Mac had an unrealized loss to a third party. The purpose of the Giant was to recognize a one time loss on selected assets to offset real gains and then prevent the Giant from being accounted for at fair value. Freddie Mac took on other actions to hide the \$1.5 billion gain in its derivatives portfolio. They included changing the accounting methodology of options on swaps and a series of so-called J-Deals in the neighborhood of \$700 million. Earnings management: The Doty report found that in 11 of 11 quarters examined, senior management of Freddie Mac changed the stated value of various reserve accounts in order to meet or exceed Wall Street's analysts public expectation of quarterly earnings.

The Doty report states "there was a longstanding practice at Freddie Mac of making discretionary accounting judgments with a view toward producing financial statements that more closely approximated analysts' estimates. Those involved in the practice report that they believe they were free to do so under the GAAP so long as the amounts involved were not quantitatively material." This is on page 57 of the report.

So my colleagues, these are serious issues. We shall listen carefully to the testimony. We will continue to monitor the developments as they follow their restatement and we may have, of course, additional hearings on this restatement. We are looking for a non-partisan solution to the challenges of improving accounting standards. Congress is not the body to set accounting standards. I believe Congress should consider, though, in light of what is happening, appointing a Blue Ribbon Commission of experts to recommend improvements in our accounting standards today.

So I encourage both members—both parties to share their ideas and we will work in a bipartisan manner to understand this and to see how to improve it.

With that, my ranking member, Ms. Schakowsky.

Ms. SCHAKOWSKY. Thank you, Mr. Chairman, and I appreciate especially your final words about the need on the part of the American public and the economy to work together in a bipartisan way to seek solutions. This hearing on the Doty report and FASB's ac-

counting standards is a very important one, and Mr. Doty, your report provides a detailed account and analysis of Freddie Mac's accounting scandal. The Doty report details how Freddie Mac manipulated its earnings reports to hide a \$1.4 billion one-time increase in earnings. This begs the question, why should—why would Freddie Mac underreport its profits?

In other corporate scandals, companies inflated their earnings. The answer is that Freddie Mac hid its profits to meet Wall Street expectations and perpetrate the impression that Freddie Mac is a stable profitable company that does not have volatile earnings. Freddie Mac's deception raises a series of questions about its corporate governance, internal controls and regulatory oversight. It also raises the question about FASB's accounting standards and how they are manipulated in the marketplace. And today we will focus on the accounting issues raised by the scandal.

Our subcommittee has an important responsibility to ensure that all companies provide clear and accurate financial information to the public. Without clear and accurate information, workers and investors are left to the whims of CEOs that may act irresponsibly. Families and institutional investors alike cannot make sound investment decisions if they know only half the story. Our publicly traded companies need to have clear, honest and accurate books. This is especially true when it comes to Freddie Mac.

Freddie Mac is not just another company. It has a major impact on the housing market and our capital markets. And this government-sponsored enterprise purchased \$592 billion of mortgages in 2002. Freddie helped finance homes for nearly 2.5 million low and moderate income families and families living in underserved areas and provided home ownership opportunities for many families that are traditionally shut out of the housing market. Freddie Mac's financial health is also an important issue for taxpayers. There has always been a general perception in the marketplace that Freddie is too big to fail. Therefore for several reasons we need to make sure that Freddie Mac is as transparent as possible.

That is why I support my colleague Mr. Markey's effort to improve Freddie Mac's transparency. In fact, Freddie's decision to register its stock with the SEC in part led to Freddie Mac's restatement of earnings. And I want to commend Mr. Markey for his leadership in this issue. And I am pleased to join him in his efforts. I look forward to hearing from today's witnesses. This is an important issue for our constituents and the U.S. Economy. Thank you, Mr. Chairman.

Mr. STEARNS. Mr. Shadegg?

Mr. SHADEGG. I thank you, Mr. Chairman. I want to thank you for holding this timely hearing on the accounting problems at Freddie Mac. As we consider proposals to prevent the reoccurrence of similar problems, it is vital to first gain an understanding of what exactly went wrong. The witnesses at today's hearing will help tremendously in that task. As a result of these investigations, there will be legislation to incorporate lessons learned from these problems as well as other potential problems with these government sponsored entities.

I believe it is critical to keep two imperatives in mind as we craft this legislation. First, we must ensure that the legislative response

is geared toward preventing the reoccurrence of similar problems. Some may argue that the specific accounting problems identified in the internal investigation by Baker Botts did not conceal problems with the financial soundness of Freddie. I believe this argument misses the point. The same attitude that gave rise to nonstandard accounting to conceal news of unexpected profits from outside analysts could just as easily have led to the use of sham accounting to hide news of significant losses.

To ensure that Freddie and Fannie remain financially sound, it is critical that legislation be crafted in such a way to prevent the reoccurrence of such inaccurate accounting and to give outside regulators and analysts a meaningful opportunity to identify a problem before it is out of control. Second, we must keep in mind the law of unintended consequences. These two institutions play an important role in making home ownership attainable for millions of Americans and improving liquidity in the mortgage market, and we must ensure that legislation does not put these missions at risk.

At the same time, we must ask whether certain privileges enjoyed by Freddie and Fannie, which are not available to similar companies—such as the exemption from reporting under the 1993 Act, are warranted or wise. Above all, we must insist on greater transparency to allow outside experts, both regulators and market analysts, to accurately monitor their financial health. I welcome our panel and appreciate, Mr. Chairman, you holding this hearing.

Mr. STEARNS. I thank my colleague.

The gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman, and thank you for holding this follow-up hearing on the accounting practices of Freddie Mac. Our last hearing occurred right before the Doty report was released, and even then we were pretty sure that the senior management at Freddie Mac was manipulating accounting standards to manage the company's earnings. Today we know that to be the case, and I am pleased that we have Mr. Doty here to enlighten us on the specifics of what went wrong with Freddie Mac.

Coming from Houston and having worked on this committee to investigate the mismanagement at Enron, I find it ironic that we are now examining a company that wanted to hide large earnings. I think the folks at Enron would like to have that problem. I know my constituents who lost their retirements or investments in Enron would like to have that problem. At any rate, we now know that Freddie Mac sought to hide \$1.4 million gained in its derivative portfolio. While this example of earnings mismanagement certainly sticks out as a major reporting problem, we must also keep in mind that the company consistently altered its earnings to meet Wall Street expectations. In fact the report tells us that the Freddie Mac managed earnings in each of the 11 quarters it studied. I can only assume that managing earnings was standard operating procedure at Freddie Mac. And I can't help but question exactly how steady, steady Freddie really is. The underlying question is how do these revelations affect investors.

And I am sure that each of us in this room have constituents who have called worried about their investments in Freddie Mac. And the constituents I hear from all say they chose to invest in Freddie Mac specifically because of its government sponsorship and

its reputation as a safe investment. In trying to maintain this reputation, however, I am afraid that Freddie Mac may have tarnished it.

So as we examine Freddie Mac as a case study on accounting principles in general, I hope we can keep our investors in mind and ensure that our work on this front ultimately increases transparency and accountability. And I thank the panel and the witnesses, Mr. Chairman. And I yield back my time.

Mr. STEARNS. I thank my colleague.

And if there is no further opening statements, all opening statements will be made part of the record. I will start with my questioning—we are going to have the opening statements first. A little eager here. So we welcome—we welcome to have your opening statement, gentleman from Nebraska.

Mr. TERRY. Waive the opening statement.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF WYOMING

Thank you, Mr. Chairman, for holding another hearing on this issue. The situation before us is not simple and it is our responsibility to address it very deliberately, thoroughly and effectively.

It is an honor to have these witnesses here today. Thank you for joining us and lending us your expertise and first-hand experience with accounting standards in the examination of what has happened at Freddie Mac. It goes without saying that your testimony will be tremendously valuable to the Committee, and play an important role in the future of corporate governance.

What has been demonstrated B or continues to come to light B is that while we have boards and standards that govern corporate disclosure, it appears that even by complying with these rules and regulations, there are still instances where shareholders and the general public have been kept in the dark about a company's true financial conditions. There is something very wrong here and it is our responsibility to work to make it right.

Notwithstanding any criminal intent or action, it is clear that we must question whether the underlying issue of regulatory power handed down by Congress and the regulations that follow, must be revisited, reshaped and reformed, if not overhauled completely. The daunting nature of even posing this question is an indication of the task at hand.

While it is not something we can answer or accomplish in our hearing today, this discussion will serve as an integral part of improving accounting standards and corporate governance. We must not get lost in the weeds of details, but maintain an accurate overall picture of what is really going on here.

The jurisdiction of this subcommittee extends its reach to the examination of accounting standards, though it is important to note that the entire picture of what has happened at Freddie Mac brings to light a myriad of issues that demand our attention. There's no question that this hearing will be another useful tool in our work to realign and strengthen how the corporate world functions.

I thank the Chairman again and yield back the remainder of my time.

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON
ENERGY AND COMMERCE

I want to Commend Cliff Stearns for his leadership today in his pursuit of accounting questions raised by Freddie Mac. We have jurisdiction over accounting standards, it is a difficult, technical area, but one of importance to investors and taxpayers. We have seen much reform in the past two years resulting from problems at Enron, Worldcom, Tyco and other names that are now household words. Accounting standards is an area that has not yet been reformed. It is one that we should look at on a bipartisan basis.

I want to commend Freddie Mac. They have cooperated with our inquiry to date, providing information and documents to both the majority and minority staff that have enhanced our understanding of the accounting issues there.

I want to draw an important distinction: while I am sure Freddie Mac regrets much of the conduct detailed in the Doty Report that we consider today, it is conduct of a lesser magnitude than we have examined in other areas. I believe that Freddie Mac is not a criminal enterprise.

I also want to commend Jim Doty. I have reviewed your report. Like Chairman Stearns, I have found it to be dispassionate, rigorous and fair. Today you will help us understand what went on at Freddie Mac.

We are also joined today by and old friend, Baruch Lev. Professor Lev, we are going to look to you and other experts to give us ideas on how FASB and accounting standard setting can be improved.

There were some serious issues raised by the Doty Report.

1. To avoid realizing a one-time gain in its derivatives portfolio of \$1.4 billion, Freddie Mac manufactured a series of transactions to generate artificial losses. Freddie Mac wished to hide this derivatives gain because it felt that it would get no credit from Wall Street if it were a one-time event. Freddie planned, instead to realize the gain over time. It also wished to avoid fair value accounting, which it believed would make its earnings more volatile.

2. In each of eleven quarters examined in the Doty Report, Freddie Mac took steps to alter its earnings to meet or exceed Wall Street Analysts expectations by one or two cents per share. This effort to increase earnings was justified because the quarterly adjustments were in the \$30-\$50 million dollar range, which Freddie believed was not material to its overall performance.

The Doty Report shows that senior management of Freddie Mac went to great lengths to achieve this accounting chicanery. They spent millions of dollars on bogus transactions that only served to move income from one quarter to another. As Professor Lev has pointed out, this is at best, wasteful of valuable economic resources that could be better used in providing housing for Americans.

An equally important question is what is permissible under GAAP. Had these transactions been structured differently, many would have been permissible.

FASB rules spend ten pages requiring firms to account for their derivatives at fair value, then 790 pages providing exceptions that allow companies to avoid the rule completely. Freddie Mac has \$600 billion in home mortgages of our constituents and \$1 trillion in derivatives. It, and other entities like it, should provide fair value accounting of these assets.

We will be looking for ways to improve standard setting. I encourage all Members to weigh in with ideas on how to achieve this goal.

PREPARED STATEMENT OF HON. HILDA L. SOLIS, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF CALIFORNIA

Mr. Chairman, thank you very much for holding this important hearing so that we may hear testimony from today's witnesses on the findings raised in the Doty report.

At the outset, Mr. Chairman, I want to say that I'm troubled by the findings in the Doty report which found significant and costly financial accounting practices at Freddie Mac.

I must state for the record that I am against corporate mismanagement, and I believe the steps that Freddie Mac has taken in recent months to rectify their poor management issues are to be commended. We as members of Congress must not allow these reported management irregularities at Freddie Mac to obscure the important role that housing GSEs play in making affordable mortgage lending available to communities across the United States. Housing GSEs were created to bring low cost capital to the housing market, a congressionally-mandated obligation that, in my experience, has done well.

We must not lose sight of the fact that Fannie Mae and Freddie Mac have harnessed their expertise in housing finance and greatly advanced access to low cost capital to millions of low and moderate-income Americans.

In closing, I am eager to learn from the panelists about how these companies can move forward into a new era of management and corporate accountability so that they may continue to make lending more affordable to our constituents.

Mr. STEARNS. Mr. James Doty, partner in charge of Baker Botts, LLP; Mr. James Barratt, senior managing director forensic and litigation advisory FTI consulting. And Professor Baruch Lev, Philips Bardes professor of accounting and finance, department of accounting, taxation and business law and department of finance, director,

Vincent C. Ross institute of accounting research, Stern School of Business.

Mr. Doty, we will start with you.

STATEMENTS OF JAMES R. DOTY, PARTNER IN CHARGE, BAKER BOTTS, LLP; JAMES W. BARRATT, SENIOR MANAGING DIRECTOR, FORENSIC AND LITIGATION ADVISORY, FTI CONSULTING; AND BARUCH LEV, PHILIPS BARDES PROFESSOR OF ACCOUNTING AND FINANCE, DEPARTMENT OF ACCOUNTING, TAXATION AND BUSINESS LAW AND DEPARTMENT OF FINANCE, DIRECTOR, VINCENT C. ROSS INSTITUTE OF ACCOUNTING RESEARCH, STERN SCHOOL OF BUSINESS

Mr. DOTY. Thank you, Chairman Stearns, Ranking Member Schakowsky, members of the panel, for having us here and giving us this opportunity. I do want to give full credit to the investigative team who has accompanied me and who has helped me do this. You have Sara Kropf, Arma Adams, Brett Scharback, Amy Gonce, Mike Barta, Steve Richards, Brad Bennett. These are people who spent a great deal of time digging out the facts of this situation. And without them, Jim Barratt and I could not have done what we have done.

I will take responsibility for the shortcomings of the report, but I want to give credit for its strengths that have been kindly noted here to this team. I also would like to inflict on the panel one historical anecdote, which my team may condemn me for, but there was a very bad man in the 18 century named Taliran whose accomplishment was that he survived the French revolution. He was asked in the middle of the terror whether the execution of a popular nobleman was a crime by the ruling regime. And Taliran responded quick as a whip as he wanted to do, well it was really much worse than a crime, it was a blunder.

Now our values have changed since the 18th century, but what we find ourselves doing in much of what we are seeing in corporate America, I think both as lawyers and as legislators, is distinguishing between crimes and blunders and attempting to determine how to treat the blunders when they become very serious threats to our economy and our financial disclosure system.

With that in mind, I think it is important to say at the outset what the investigation did not find at Freddie Mac. There was no indication that the company was creating fictitious profits. Nothing we found called into question the fundamental safety and soundness of the company. While we found misapplications of accounting principles, our investigation did not reveal rampant criminal conduct, misappropriation of covert funds for personal gain, or others of the types of intentional wrongdoing that have characterized recent scandals.

Rather, we found a company that was focused on risk management, but responsive, probably too responsive to the market expectation of steady, nonvolatile earning growth. The market expectation was, at times, clearly at odds with the reality of the business as the business had developed in the past decade. To remind the committee, since 1989, the company has evolved from a quasi-governmental entity to a public company that is a major participant in international capital markets. This period also marked a funda-

mental shift in the company's business as it retained more of the purchased mortgages as long-term investments, this is the so-called retained portfolio.

Many of the challenged transactions were the result of the tension of the changing business reality of managing that retained portfolio and the determination of management to maintain the image of steady Freddie by delivering quarterly and annual earnings expected by analysts. We will talk about these transactions, but that tension is what you see in much of this story. Missing at Freddie, missing at Freddie Mac was a sufficient boundary marked by the company's accounting professionals to discipline the goal of steady Freddie and to ensure that capital market transactions and reserve policies were accounted for properly. The accounting errors that led to the restatements resulted, in large part, from inadequacies in corporate accounting, in responding to the accounting rules applicable to derivative transactions, most notably SFAS 133 and SFAS 125 and initiatives within corporate accounting with respect to managing reserves.

The challenges faced by corporate accounting were exacerbated by rapid growth in the company's retained portfolio of mortgage loans and the associated exposure to volatility in reported earnings. However, the practices that enabled the company to report earnings smoothed to within two to three cents per share of analysts expectations involved reserve adjustments not simply capital market transactions. Combination of techniques.

It is important to note that notwithstanding the various accounting errors, we found nothing to suggest that the transactions at issue had the effect of undermining the company's risk management policies and practices. Indeed, it was the maintenance of the risk management policies and the avoidance of changing the character of the portfolio that undermines the accounting treatment. As discussed in the report, we did find problems. We found weaknesses in the company's internal compliance and governance processes, disclosure practices that fell below the standards required of a public company, weaknesses in corporate accounting that resulted in excessive reliance on independent auditors.

In many of the cases that Mr. Green and others are familiar with, the company had excluded their independent auditors from many of the planning of complex transactions that resulted in accounting error. This is a case that the company relied excessively on independent auditing advice because it did not have in house the capacity and the expertise to make these judgments. The role of senior management is a focus of the report. Employees in F&I, corporate accounting and other business units were expected by senior management to take actions that would help achieve the goal of steady nonvolatile earnings growth. The board of directors was aware of the goal, but the flow of information was so controlled by former management, that the accounting challenges involved in executing those strategies was not fairly presented to the board.

Finally, even as the board and its audit committee members became increasingly concerned over the apparent length of depth and expertise in corporate accounting, senior management failed to take prompt corrective action demanded by the board, a failure that had serious consequences. These governance problems are the

focus of a robust remediation effort now going forward at Freddie Mac under the oversight of the board and the direction of the new CFO. But that's the governance side. I would like to take a bit of time to talk about the underlying accounting issues that are of interest to this committee. There are three groups of rules that we think that are within your purview and are clearly implicated in the issues that you are concerned with. One is SFAS 135, Statement of Financial Accounting Standards 133. Our report describes several transactions that were entered into in late 2000 and early 2001 in response to changes in accounting rules, most notably 133.

SFAS 133 required the company to record derivative instruments on its balance sheet at fair market value, that is to say, marked to market through earnings, through income. And that would have commenced in January 1, 2001. SFAS 133 has been criticized as an example of a rule based rather than principle based accounting standard. The concern has been expressed that as such, SFAS 133 might encourage a check-the-box approach that eliminates judgment from application of the standard. It is, nevertheless, GAAP. SFAS 133 was GAAP. Without commenting at this point on the action the company took in response, we note two findings that we made.

First, the company believed that the transition to 133 marked to market accounting to distort the financial condition of the company by producing a one time gain for which the company would not receive credit from analysts and investors and by creating artificial in their view artificial earnings volatility in future periods. Second, in what we saw to be a common theme in many of these transactions, management believed that SFAS 133 should be transacted around because it did not reflect the economic fundamentals of the company's business. The most instructive business was the Coupon Tradeup Giant transaction, the CTUG, which involved a reclassification, portfolio assets with embedded losses from the health to maturity account to the trading account and then reclassifying those securities from trading back to available for sale.

And that would have resulted in losses going into the income statement without avoiding the volatility in the future of appreciation of those assets. Now although the company and its independent auditors have now determined that that transaction was not compliant with GAAP, it is, as was noted possible that some of the transaction structure adjustments would have permitted it to avoid failing under 125. But the important thing for the committee here is what was missing in this attempt was a real transfer of risk and a real change in the beneficial ownership and the structure and character of securities held in the retained portfolio. It is the tension that I was describing.

In other words the accounting transaction would have gone through the 133, the SFAS 133 test, if it had met the test of SFAS 125, which required a real transfer and a beneficial ownership change. And that did not happen because the persons managing the retained portfolio were unwilling to compromise the quality, the character and the structure of that portfolio merely to accommodate an accounting result.

So you had a tension within the company that results in as they tried to back away from and avoid 133, they bumped into SFAS

125 and they did that because they did not engage in real risk transfer. Again, they violated GAAP. SFAS 91 required the company to amortize the value of premiums and discounts over the estimated life of a mortgage pool. Mortgages are prepaid. Mortgages carry penalties and premiums. The company is required to book a catch up adjustment to income when those prepayments and discounts—when those premiums and discounts exceed the estimated amortization rate or the estimated rate of prepayment and discount. The model that generates that range of value, if it is violated by actual experience, results in a charge to earnings.

The company again believed that this resulted in volatility in its earnings and it responded by creating a band within which it charged these adjustments to a reserve account. The reserve account is not permitted by GAAP. The reserve account was used to smooth out the effect of prepayments and discounts in the mortgage pool. But worth noting for the committee, is that the use of a nonGAAP reserve for this purpose was fully transparent to the company's then public accounting firm which tolerated the practice as long as the amounts involved were not quantitatively material. That is a second category of the problem we found.

A third category, which is encompassed within the report is SFAS 5, which many of you know relates to the accounting for loss contingencies. And it requires that a company's reserves be based on probable losses. As noted in our report in a number of instances, the company made management adjustments to reserve accounts and altered the models that supported reserve policy with a view to presenting a steady nonvolatile pattern of earnings growth. These reserve adjustments frequently were not supported by documentation in accordance with GAAP.

As such, the reserve policy reflected a purpose of moving earnings to within a penny of two of analysts' estimates of earnings per share rather than as a balanced assessment of the underlying experience and losses required by reserve policy. The foregoing summary is intended just to convey the three major areas of accounting policy that are implicated by the transactions involved. There are capital market transactions, reserve policy and management reserve adjustments. They were all three affected in violation of GAAP. They were all three affected without adequate public disclosure. All three of them raised serious concerns for the company that Freddie Mac is setting about attempting to fix. And with that, I thank you for your attention and I would be happy to take your questions when the other witnesses have testified.

[The prepared statement of James R. Doty follows:]

PREPARED STATEMENT OF JAMES R. DOTY

Chairman Stearns, Ranking Member Schakowsky and members of the Subcommittee: Thank you for inviting me to testify today concerning our investigation of certain accounting matters for the Board of Directors of the Federal Home Loan Mortgage Corporation ("Freddie Mac" or the "Company"). Details of the investigation and our conclusions are set forth in our Report dated July 22, 2003. I would like to speak today to those findings and their implications for the significant work of this Subcommittee and your ongoing concern with accounting standards.

I.

It is important at the outset to say what we did not find. There was no indication that the Company was creating fictitious profits. Nothing we have found calls into

question the fundamental financial safety and soundness of the Company. While we found misapplications of accounting principles, our investigation did not reveal rampant, criminal misconduct, misappropriation of corporate funds for personal gain, or the other types of intentional wrongdoing that have characterized recent scandals. Rather, our investigation found a company focused on risk management, but responsive—perhaps overly so—to the market expectation of steady, nonvolatile earnings growth. That market expectation was, at times, apparently at odds with the reality of the business as it has developed over the past decade.

Since 1989, the Company has evolved from a quasi-governmental entity to a public company that is a major participant in international capital markets. This period has also marked a fundamental shift in the Company's business as it has retained more of the purchased mortgage loans as investments (the "Retained Portfolio").¹ Many of the challenged transactions were the result of the tension between this changing business reality and the determination of senior management to maintain the image of "Steady Freddie" by delivering the quarterly and annual earnings expected by analysts.²

Missing at Freddie Mac was a sufficient boundary, marked by the Company's accounting professionals, to discipline the goal of "Steady Freddie" and to ensure that capital market transactions and reserve policies were accounted for properly.

The accounting errors that led to the restatements resulted in large part from the inadequacies of Corporate Accounting in responding to the accounting rules applicable to derivative transactions, most notably SFAS 133 and SFAS 125, and initiatives within Corporate Accounting with respect to managing reserves. The challenges faced by Corporate Accounting were exacerbated by rapid growth in the Company's Retained Portfolio of mortgage loans, and the associated exposure to volatility in reported earnings. However, the practices that enabled the Company to report earnings "smoothed" to within 2 cents to 3 cents per share of analysts' expectations involved reserve adjustments, not simply capital market transactions.

It is also important to note that, notwithstanding the various accounting errors, we found nothing to suggest that the transactions at issue had the effect of undermining the Company's risk-management policies and practices. As discussed in our Report, we did find problems: (i) weaknesses in the Company's internal compliance and governance processes; (ii) disclosure practices that fell below the standards required of a public company; and (iii) weaknesses in Corporate Accounting that resulted in excessive reliance on independent auditors with respect to accounting decisions and policies.

The role of senior management is a focus of the Report. Employees in F&I, Corporate Accounting and other business units were expected by senior management to take actions that would help achieve the goal of steady, nonvolatile earnings growth. The Board of Directors was aware of this goal but the flow of information was so controlled by former management that the accounting challenges involved in executing particular strategies were not fairly presented.

Finally, even as Board and Audit Committee members became increasingly concerned over the apparent lack of depth and expertise in Corporate Accounting, senior management failed to take the prompt corrective action demanded by the Board, a failure that had serious consequences. These governance problems are the focus of a robust remediation effort now going forward at Freddie Mac, under the oversight of the Board and the direction of the new CFO, Martin Baumann.

II.

Now, I shall turn to some of the underlying accounting issues that seem to me most germane for the Subcommittee.

SFAS 133

Our Report describes several transactions³ that were entered into in late 2000 and early 2001 in response to changes in accounting rules, most notably SFAS 133.⁴

¹The opinions expressed to us by the Company indicate that the referenced growth of the Retained Portfolio was one factor enabling Freddie Mac to perform its mission in furthering the liquidity of the secondary mortgage market through crises such as the implosion of Long Term Capital Management and other international financial crises of the 1990's.

²These matters are now being investigated by the Securities and Exchange Commission, the Department of Justice, and the Office of Federal Housing Enterprise Oversight and nothing in this testimony is intended as a comment on those investigations.

³CTUG, Swaptions Portfolio Valuation and J-Deals.

⁴*Statement of Financial Accounting Standard No. 133* ("SFAS 133"), Accounting for Derivative Instruments and Hedging Activities. The range of the accounting standards involved in the in-

SFAS 133 required the Company to record derivative instruments on its balance sheet at fair market value (*i.e.*, marked-to-market through income) beginning January 1, 2001. SFAS 133 has been criticized as an example of a rule-based, rather than principle-based, accounting standard. The concern has been expressed that, as such, SFAS 133 might encourage a check-the-box approach that eliminates judgment from the application of the standard.

Without commenting further on the action the Company took in response, we note two findings. First, the Company believed that the transition to SFAS 133 would distort the financial condition of the Company by producing a one-time gain for which the Company would not receive credit from analysts and investors,⁵ and by creating artificial earnings volatility in future periods (requiring that some derivatives be marked-to-market but not permitting similar treatment of the debt economically hedged by those derivatives). Second, in what we saw to be a common theme in many of the transactions we investigated, management believed that SFAS 133 should be “transacted around” because it did not reflect the economic fundamentals of the Company’s business.

The most instructive example of this response was the CTUG transaction, which was intended to offset the one-time transition adjustment gain under SFAS 133 by reclassifying certain portfolio assets with embedded losses from “held-to-maturity” to “trading” (producing a loss that would be reported in the transition adjustment line on the Company’s income statement) and then reclassifying the securities from “trading” to “available-for-sale” (an asset classification that does not require mark-to-market accounting and so would not produce earnings volatility in the future).

Although the Company and its independent auditors have determined that the transaction was not compliant with GAAP, it is possible that with certain adjustments to the transaction structure the Company would have satisfied GAAP. Specifically, the most serious GAAP problem with the CTUG arises not under SFAS 133, but under the transfer and control requirements of SFAS 125.⁶ These flaws could have been addressed by transactional changes. SFAS 133, in paragraph 54, invites reporting companies to attempt precisely what Freddie Mac attempted—to transfer held-to-maturity derivatives into trading and thereby offset this one-time gain with the embedded losses.

The Swaptions Portfolio Valuation and the J-Deals were similarly entered into in order to avoid volatility in financial results.⁷ The J-Deals, if structured and executed differently, could have achieved the Company’s intended results (consistent with SFAS 125 and SFAS 115).

SFAS 91

As described in our Report, SFAS 91 required the Company first to amortize the value of premiums and discounts over the estimated life of a mortgage pool, and then to book “catch up” adjustments to the income statement when actual prepayments differed from estimates. Again, the Company believed that, as applied to it, this accounting standard produced misleading results that tended to overstate the volatility of the Company’s business. The Company responded by creating a “band,” and by booking the catch up adjustment (so long as it fell within this band) to a special reserve account, rather than the income statement. On one occasion, the Company also changed its assumptions about interest rate yield curves, again with an eye toward reducing volatility in its reported financial statements.

Worth noting, however, is that the use of a non-GAAP reserve for this purpose was fully transparent to the Company’s then-public accounting firm, which tolerated the practice so long as the amounts involved were not quantitatively material.

SFAS 5

SFAS 5 provides that a company’s reserves be based on “probable” losses. As noted in our Report, in a number of instances, the Company made “management adjustments” to reserve accounts and altered the models that supported reserve pol-

vestigated transactions was not, of course, limited to SFAS 133, but included SFAS 125, SFAS 140, SFAS 107, SFAS 115, SFAS 91, SFAS 5, EITF 99-20 and EITF D-14.

⁵This gain would be measured by the difference between the previous, or carrying, value of the derivative, and its fair value.

⁶*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

⁷Later in 2001, the Company entered into a series of transactions known as the “Linked Swaps,” which had the effect of transferring approximately \$420 million in operating earnings into later years. The Linked Swaps, which were executed at the direction of senior management, had minimal business justification other than the shifting of operating earnings. Linked Swaps are also problematic in that they were designed to shift a non-GAAP metric, “operating earnings,” that senior management had identified as the key financial metric that the market should refer as reflecting the true economics of the Company.

icy, with a view to presenting a steady, nonvolatile pattern of earnings growth. These reserve adjustments frequently were not supported by documentation in accordance with GAAP. As such, the reserve policy reflected a purpose of moving earnings to within a penny or two of analysts' estimates of earnings per share, rather than a balanced assessment of the underlying probable losses.

The foregoing summary covers the three major areas of accounting policy implicated by the transactions investigated—capital market transactions, reserve policy and management reserve adjustments.

Thank you again for the opportunity to appear; and I will be happy to take your questions.

Mr. STEARNS. I thank the gentleman and Mr. Barratt.

STATEMENT OF JAMES W. BARRATT

Mr. BARRATT. Good morning. Chairman Stearns and members of the subcommittee, thank you for the invitation to appear here today. My name is James W. Barratt and I am a senior managing director in the forensic and litigation advisory practice of FTI Consulting here in Washington, DC. I am a CPA and have over 19 years of experience in accounting, auditing and investigations, including several years as an accountant in the division of enforcement at the SEC. FTI consulting is a multi discipline consulting firm with practices in the area of financial restructuring and litigation consulting.

In December 2002, James Doty of the law firm of Baker Botts retained FTI to provide forensic accounting consulting services in connection with the internal investigation requested by the audit committee of the board of Freddie Mac. FTI possessed the forensic accounting experience and the electronic evidence consulting resources to assist in conducting this investigation. Over the course of several months, members of FTI and Baker Botts worked closely together to conduct the internal investigation. The FTI forensic accounting teams performed analyses of various accounting and financial reporting issues related to derivative transactions and reserve accounts.

The FTI electronic evidence team supported the forensic accountants and the attorneys in the electronic evidence gathering and the analysis. That process included the imaging of numerous hard drives, obtaining stored e-mails and other data from network servers and identifying relevant documents through key word searches and other techniques. On July 23, 2003, the report on the results of the investigation was made to the board of directors of Freddie Mac. As stated in the report, our purpose was to conduct a fact-finding investigation. To that end FTI has assisted Baker Botts in developing an understanding of the structure, execution and accounting implications of each of the specific transactions. Our purpose has not been to test whether the accounting was correct, because the company had already determined the accounting was in error. I welcome the opportunity to assist the subcommittee in the hearing today. Thank you.

[The prepared statement of James W. Barratt follows:]

PREPARED STATEMENT OF JAMES W. BARRATT, SENIOR MANAGING DIRECTOR,
FORENSIC AND LITIGATION ADVISORY PRACTICE, FTI CONSULTING

Chairman Stearns, Ranking Member Schakowsky and members of the Subcommittee:

Thank you for the invitation to appear here today.

My name is James W. Barratt and I am a Senior Managing Director in the Forensic and Litigation Advisory Practice of FTI Consulting ("FTI") in Washington, DC. I am a CPA and have over 19 years of combined accounting, auditing, and investigative experience including serving several years as an accountant in the Division of Enforcement of the U.S. Securities and Exchange Commission.

FTI Consulting is a publicly traded, multi-disciplined consulting firm with leading practices in the areas of financial restructuring and litigation consulting.

In December 2002, James Doty of the law firm of Baker Botts, L.L.P. ("Baker Botts") retained FTI to provide forensic accounting consulting services in connection with an internal investigation requested by the Audit Committee of the Board of Directors of Freddie Mac. FTI possessed the forensic accounting experience and electronic evidence consulting resources to assist in conducting the investigation.

Over the course of several months, members of FTI and Baker Botts worked closely together to conduct the internal investigation. The FTI forensic accounting teams performed analyses of various accounting and financial reporting issues related to complex derivative transactions and reserve accounts. The FTI electronic evidence team supported the forensic accountants and the attorneys in the electronic evidence gathering and analysis process. That process included the imaging of numerous hard drives, obtaining and storing e-mails and other data from network servers, and identifying relevant documents through keyword searches and other techniques.

On July 23, 2003, the Report on the results of this investigation into accounting and financial reporting matters was made to the Board of Directors of Freddie Mac. As stated in the Report, our purpose was to conduct a fact-finding investigation. To that end, FTI has assisted Baker Botts in developing an understanding of the structure, execution, and accounting implications of each of the specific transactions. Our purpose has not been to test whether the accounting was correct because the Company has already determined that the accounting was in error.

I welcome the opportunity to assist the Subcommittee in the hearing today.

Mr. STEARNS. I thank the gentleman. Professor Lev.

STATEMENT OF BARUCH LEV

Mr. LEV. Thank you for the opportunity to be here. I would like to comment briefly on two subjects. One is on several important issues that if I were writing this report I would have included them in the report or emphasized them somewhat differently, although I find the report outstanding. And the second issue is some serious deficiencies in what is known as GAAP, generally accepted accounting principles that come to light once more in Freddie Mac.

So I start with my comments on the several issues in the report. The first one, I call if it complies with GAAP, it is fine. I think the attitude, Freddie Mac's attitude at least at the time, is expressed beautifully in footnote 67 of the report when they say Parseghian has acknowledged that he was aware of the use of reserves to meet earnings goals but understood these reserves are being managed consistent with GAAP.

This means that you can manipulate because using reserves to meet goals means manipulating your earnings simply. You can manipulate as long as it is consistent with GAAP. They also quote the auditor, Arnall indicated to us Arthur Andersen viewed its role as being focused on GAAP measure. And even the report itself is somewhat GAAP centric, for example, they mention several times that a major measure indicator operating income that was manipulated by Freddie Mac is not a GAAP measure as if that is a mitigating circumstance. Investors of course are not really concerned whether financial information reports are consistent and comply with GAAP. What they are concerned with is whether they comply with reality. Whether earnings, asset liabilities that are reported to them are truthful, that present reality.

Just to give you an example from buying a house which I did recently, you speak with the engineer and you ask the engineer about foundations of the house and whether there are leakages, and suppose he or she tell you, well, the house meets the ordinance or the regulation. Who cares about this? What you care is reality. And that is the issue of GAAP or reality behind GAAP, which I would if I wrote the report I would have emphasized more.

Second issue I call, what about investors? When you read the report and again it is an outstanding report, but when you read the report you somehow get the impression that by the end of the day no harm was done. I just quote one sentence. They say on page 31, they say transactions discussed below didn't compromise the company's risk management strategy, will not have an apparent effect on safety and soundness. Perhaps I am not sure about that, but perhaps. But what about compromising investors. Information was manipulated. Investors made decisions based on this information, must have compromised their decision; must have compromised resource allocation in capital markets, which is a foundation of the economy. Third issue is which is really related to some extent to the one I just talked about is the social costs. Mr. Doty and rightfully so emphasized that they didn't find any misappropriation of funds, but huge amount of funds were misappropriated, perhaps not by individuals but just by all the schemes that were done.

If you think about the scores of people that spend hours and hours probably days and weeks of scheming and perpetrating these things and then coming up with all kinds of mechanisms and financial instruments that were very costly, legal fees, transaction costs, what about this misappropriation of funds. And probably the most serious of all here is that a climate of manipulation and intrigue must have permeated Freddie Mac. The report quotes, and again it is a beautiful thing, they quote a trader speaking to another trader and the trader says, what we do is basically book expense now and get it back in 6 months. Almost like a joke. And he says keep it under your hat. I don't want to see expletive deleted Bloomberg about this trade either.

How do you think a major company—I saw Freddie Mac ranked among the 20 largest companies in the world in terms of assets—how do you think the business of the company is conducted when this kind of climate permeates there. And the last point on the report, I find it a little too forgiving. For example, the report says Freddie Mac sought to avoid making any disclosure that would require subsequent explanation or lead investors to draw any conclusion other than the one management believed best reflected economics of company's business. There is a very simple way if managers are convinced that a new accounting rule doesn't reflect economics of the business, there is a very simple way or ways dealing with it. Companies are doing it daily. One is to call a press conference or financial analyst conference and explain it to them, that this is just a one time item and will never reoccur again.

And the second which lots of companies are again are to issue pro forma earnings and to say these are GAAP earnings but they don't reflect reality. Here are the earnings that reflect reality and that is the reasons why. You don't resort to schemes or manipulations which of course you don't disclose in order to somehow retain

the economics of the business. My second subject and again very briefly is really the big picture, which Freddie Mac is only a small part of the puzzle. And that is what comes to be known as GAAP, generally accepted accounting principles.

All the scandals we had, starting recently, starting with Enron and culminating now with Freddie Mac, they all expose fundamental deficiencies, fundamental weaknesses of the accounting system which now mushroomed to tens of thousands of pages of extremely detailed instructions of how to account and how to report for every single transaction, which of course is a lost cause. It is hopeless, because once the FASB after about 2 years of deliberation comes out with new instructions, smart bankers, lawyers, accountants take about 10 minutes to transact around this, change the contract and transact around it—the new rules and the report gives great examples of how Freddie Mac did it and it is constantly done. So this whole thing is really, really hopeless. But what is so dangerous about an extremely complex system is that crooks thrive in complex environment.

Crooks thrive in the tax system because it is so complex. Crooks recently thrived in the worldwide Web because it is so complex. And crooks definitely thrive in GAAP because it is so complex. Why do they thrive? Because they have the most to gain. And they employ the best experts in doing so. So that is a major problem. Sarbanes-Oxley, I wrote in my report, they instruct the accounting regulators to study, move away from rule-based to principle-based. There is some study by the FASB. I don't see any real change in this direction. And the second and last issue of major problem with GAAP is the fundamental ability to manipulation. Non accountants believe that accounting is about facts.

Accounting is about a few facts and a huge number of estimates, judgments, even just sheer guesses. Just to give you one example. One of the largest item in the income statement is pension expense particularly for labor intensive companies. To estimate the pension expense, you have to estimate the gain on your portfolio of pension assets, the money that was put aside; the gain on this portfolio next year.

Now who can estimate that what the stock market will do next year. It is absurd. But this is a large part of the measurement of income. What is really serious is that the huge amount of reserve and accounting finances has shown two things: A, that managers are managing, manipulating earnings on a very large scale, particularly by misusing these estimates because no one can order an estimate; and second is that investors fall into the trap and pay for it.

Just to give you an example how widespread this manipulation is to give you a big picture. I just checked yesterday with First Call, which is a service that tracks financial analysts' forecast of earnings and then the earnings reports by companies. I asked them to give me information about Standard and Poor 500 companies. These are the 500 largest companies in the United States, roughly, 70 to 75 percent of the whole U.S. Economy. 40 percent in the last 4 quarters, 40 percent of Standard and Poor 500 companies exactly matched to the penny, to the penny analysts forecasts or beat by a penny analysts forecast. I tell you, based on my experience in

business and accounting, that for a huge organization which is spread worldwide with sometimes hundreds of thousands of employees, to meet by a penny an outside target without manipulation, it is an impossibility.

So this is the environment that you are dealing with. And we really have to see the large picture here. I really urge you if I may to do two things: A, come up with ways or generate ways to strengthen the controls and the transparency of Freddie Mac, but equally important, to start dealing with the big issue with the accounting system known as GAAP. Thank you.

[The prepared statement of Baruch Lev follows:]

PREPARED STATEMENT OF BARUCH LEV, PHILIP BARDES PROFESSOR OF ACCOUNTING AND FINANCE, STERN SCHOOL OF BUSINESS, NEW YORK UNIVERSITY.

My observations and comments concerning the July 22, 2003 report (Report) of the board of Freddie Mac (hereafter the Company) prepared by Baker Botts L.L.P. relate to two issues: (1) What, in my opinion, is missing from or not sufficiently emphasized in the report, and (2) the accounting regulatory environment, known as GAAP (generally accepted accounting principles). I would like to state at the outset that I find the Report thoughtful, insightful, and very well articulated.

I. MISSING FROM THE REPORT

1. *If it complies with GAAP, it's fine.*

The attitude of the former management of Freddie Mac toward financial reporting seems well represented by Mr. Parseghian (a former top executive): "*Parseghian has acknowledged that he was aware of the use of reserves to meet earnings goals, but understood that these reserves were being managed consistent with GAAP.*" (footnote 67). Thus, according to this view, financial information can be "managed" by elaborate devices aimed to make investors believe that the Company's performance is different from reality (otherwise, why manage?), as long as the scheme is within the wide latitude allowed by GAAP. This exclusive GAAP concern is also echoed by the Company's chief auditor: "*Arnall indicated to us that Arthur Andersen viewed its role as being focused on GAAP measures.*" (p. 85). GAAP is also the standard against which the Report evaluates the various schemes and transactions perpetrated by the Company (e.g., "These errors appear to us to have been a good faith misapplication of GAAP..." p. 53). Also, a closely-watched indicator which was manipulated by the Company—operating earnings—is somewhat mitigated in the Report, because it's a "non-GAAP metric."

For investors and other constituencies, GAAP compliance is of secondary importance. What these users of financial reports need is information that *complies with reality*. They need to be assured that the financial reports portray a truthful and unbiased picture of the Company's real earnings, assets, and liabilities, rather than that management's practices conformed with GAAP, known for its wide latitude and ease of manipulation.

The absence of a culture of honesty and integrity at the Company, manifested by the extensive efforts to manage the information conveyed to investors, some in compliance with GAAP and others not, is not sufficiently condemned in the Report.

2. *What about investors?*

While detailing the extensive schemes of the Company to manipulate its financial information, the Report does not elaborate on the damage inflicted on the information users. One, therefore, may get the impression that no serious harm was done. Thus for example, the Report states (p. 31): "The transactions discussed below did not compromise the Company's risk management strategy... will not have an apparent effect on safety and soundness." But what about compromising the multitude of investors who relied on the "managed" information? Surely, the Company's managers would not have resorted to such elaborate and costly schemes as described in the Report, unless they believed that investors will react in an "undesired manner" to the truth. Tampering with information by a major player in capital markets such as Freddie Mac adversely affects resource allocation in the economy. Not a small matter.

3. *The social cost of manipulation*

Management and manipulation of financial information seriously damages investors and the resource allocation process of capital markets, and inflicts additional costs on society at large. The Report details the extent of the Company's schemes: scores of high ranking employees from accounting, trade, legal, tax, shareholder relation and other departments were engaged for considerable time periods in a socially wasteful activity of managing information. This substantial time, effort and management attention should, of course, have been devoted to further the real objectives of the Company.

In addition to efforts and time, substantial monetary resources (legal fees, transaction costs) were wasted in structuring deals and financial instruments which, according to the Report, had no real business purpose. All this is a dead weight loss on society.

But, perhaps the most serious damage resulted from the climate of manipulation and intrigue that must have permeated wide echelons of the Company, and even spilled outside. Thus, for example, a Company's trader speaking to a colleague explains that the reason for the trade is: "book expense now and get it back in six months." He advises the trader to "keep that under your hat." And states: "I don't want to see any [expletive deleted] Bloomberg about this trade either." (p. 75). One can only speculate about the adverse impact of a social climate, where employees are motivated to manage information (Dean's performance evaluation, p. 45), on Freddie Mac's business activities and performance.

4. *Report too forgiving*

A theme that runs through the Report is that the Company's management "just" wanted to portray reality. Apparently, no intention to deceive. Thus, the Report says: "Freddie Mac sought to avoid making any disclosure that would require subsequent explanation or lead investors to draw any conclusion other than the one management believed best reflected the economics of the Company's business." (p. 53).

This is admirable, if not for the numerous, detailed descriptions in the Report of different managerial objectives, such as to portray a steady growth of earnings; to eliminate reported volatility; to meet analysts' forecasts; to hide large gains until "needed" in the future, and so on. Obscuring earnings volatility, and making investors believe that the Company meets prescribed targets does not strike me as just intended to reflect "the economics of the business."

II. GAAP DEFICIENCIES

In addition to exposing the reader to what transpired within Freddie Mac, the Report implies volumes about GAAP, the framework of accounting and reporting rules governing public companies' financial reporting. In particular, the Company's nefarious activities shed light on two major GAAP deficiencies: extreme complexity, and vulnerability to manipulations. These deficiencies were, of course, evident in the numerous corporate scandals that surfaced during the last three years, yet they did not receive adequate attention by policymakers.

1. *GAAP Complexity*

The Report comments repeatedly on the complexity of GAAP, and in particular the FASB statements on financial instruments—the trigger of much of the Company's manipulations (e.g., "The errors . . . resulted in large part . . . from inadequacies in responding to complex accounting rules . . ." p. V). GAAP developed over time to become an incredibly detailed set of rules and instructions, stretched over tens of thousands of pages, constantly changing in an attempt to prescribe the accounting and reporting of every new event and business development. By its nature and the long deliberation process, GAAP is always "behind events," because once a new rule emerges, business contracts are changed to "transact around" the rule. Freddie Mac's Report provides telling examples of financial instruments and deals structured and executed solely to thwart GAAP.

The extreme complexity, detail, and the constant change of GAAP have various unintended consequences. One of the most serious is that the complexity gives significant advantage to those, like the Company, who intend to misuse the rules, because those people and entities have sufficient incentives to invest the time and money required to comprehend GAAP. It is well known that crooks thrive in complex environments (e.g., the World Wide Web).

Sarbanes-Oxley attempted to deal with this issue by instructing accounting regulators to move away from rules-based and toward a principles-based accounting system. My impression is that such a move did not reach far. In fact, GAAP complexity marches on.

2. Vulnerability to manipulation

Laymen are generally under the impression that accounting is all about facts. Few things are farther from the truth. Accounting is about some facts, and a lot of judgments, estimates, and outright guesses. The measurement processes underlying the determination of earnings and the valuation of asset is replete with estimates, such as the provisions for depreciation and amortization, bad debts, pension expense, warranties, asset impairments, and so on. The current move of accounting regulators toward "fair value accounting" enhances considerably the role of estimates in financial reports. Thus, the Report (p. 47) quotes from GAAP concerning the fair value of financial instruments which affects both earnings and asset values: "If quoted market prices are not available, management's best estimate of fair value may be used..." The Report is explicit about how the Company's management "best estimated" fair values.

Extensive research has shown that accounting estimates are: (1) widely used by managers to manipulate financial reports, and (2) systematically deceive investors and thwart resource allocation in capital markets. The reason: good, honest estimates cannot be regulated, or audited effectively, nor is it straightforward to prove after the fact that an estimate, even widely far off the mark, was intentionally misleading.

One can get an idea about the current prevalence of earnings management by large U.S. corporations, mostly by misusing estimates, from the startling data (obtained from Thomson's First Call) that during the last four quarters, over 40% of the S&P 500 companies met to the penny, or beat by a penny the consensus earnings forecasts by financial analysts. It is virtually impossible for a large, complex business enterprise, operating in a volatile environment, to meet to the penny an external earnings forecast, without some "management."

The vulnerability of GAAP to manipulation by misusing the multiple estimates underlying accounting is amply demonstrated in the Report. This vulnerability, with its adverse economic and social consequences has not received the required policy-makers' attention.

III. POSTSCRIPT

Freddie Mac adds to the variety of recent corporate scandals the case of a company that understated, rather than overstated its earnings. This, however, is not a mitigating factor. Understated earnings today, are often used to overstate earnings tomorrow. The accounting manipulations described in the report are serious and require remedial actions. But one should not lose sight of the bigger picture: the events described in the Report point once more at fundamental vulnerabilities of GAAP, which so far have not been adequately addressed.

Mr. STEARNS. Professor Lev, thank you.

At this point I will start to question. Professor Lev, you have used the word manipulation, scheming, intrigue. So obviously you would not agree with Mr. Doty's analysis. This is simply blunders.

Mr. LEV. I will not call those "blunders."

Mr. STEARNS. Mr. Doty, in light of the fact that you have used the word "manipulation," manipulation does not imply a blunder. And Mr. Lev, you are saying 40 percent of the Fortune 500 companies might be doing pretty much the same thing. Is that what you are implying?

Mr. LEV. I think, of course, investigate it.

Mr. STEARNS. You are saying the probability of all of them coming in with one cent of the analysts' prediction, 40 percent of the Fortune 500 cannot be done. There is no probability they would meet that.

Mr. LEV. Extremely low. I don't want to instruct people how to do these things, but they do really two things: They manage the forecasts by continuously talking to analysts and gauging the forecast, and then they manage the earnings to meet the forecast. So they come from two directions.

Mr. STEARNS. This committee has jurisdiction over FASB so we are trying to understand how to reform and change GAAP. To do

this, let us take a real life example and I will start with Mr. Doty. In reading through this report, this Giant transaction is perhaps the most outstanding one. It occurred on a very large amount, \$30 billion and the report said it occurred within several hours. So we transferred \$30 billion to create a net loss in several hours in a buyback. Can you just maybe in very simple sentences tell us what a Giant transaction is and is it used by all the other Fortune 500 companies, or is that only something Freddie Mac did?

Mr. DOTY. Mr. Chairman, we don't know about—

Mr. STEARNS. This is not a customary thing. This is something Freddie Mac created.

Mr. DOTY. Doing something which SFAS 133 invites. The new accounting rule invited companies—and I love this transaction, chairman, because it does illustrate the complexities that you are dealing with in your committee. The rule invited companies to avoid the one-time marked to market spike in their reported earnings by reclassification transactions. It was permitted to reclassify securities that were held in the health to maturity account, out of that account to trading or available for sale.

This transaction was a reclassification of securities first from health to maturity to trading, involved a sale to a third party, assemblage in a coupon Giant, transferred back to Freddie Mac, and then a transferred into available for sale so that future appreciation would not affect earnings. It failed not because it was attempting something which was inconsistent with the purpose of 133, but because the techniques of that elaborate transaction failed the transfer of risk and the beneficial ownership and control provisions of SFAS 125.

Mr. STEARNS. No real transfer of risk was the violation, but not what they did.

Mr. DOTY. And that is because the division of the company owning the securities, F&I was not willing to undergo the change of the security ownership positions that would have been needed to satisfy the accounting technique. They were insistent on keeping those securities which they wanted in the portfolio. So you have, in effect, a tension within GAAP between rules, SFAS 133, which does not presume that volatility is good and steady earnings are bad. It is accounting neutral. But it creates problems for companies that are trying to navigate that.

Mr. STEARNS. You would admit, though, to do a transaction of that complexity required a lot of foresight and scheming and intrigue, manipulation. And the fact that no real risk—no real transfer of risk was involved, these folks knew that when they did it, didn't they?

Mr. DOTY. They did.

Mr. STEARNS. People who had that kind of knowledge to do that kind of transaction surely understand risk and surely understand that when you do that, you have to transfer that risk and that wasn't done. Mr. Lev, let me ask you, we are going to have a second round of questioning here, but how do you think GAAP should be changed to stop something where people do this with no real transfer of risk and for the average person to realize they are transferring \$30 billion over 2 hours just to create a bogus number so they can get earnings in line with expectation of analysts?

And Mr. Doty mentioned that these people felt that the GAAP did not reflect Freddie Mac's business actions. They made that decision. So evidently accountants and business people can say to themselves, you know, we are going to take this into our own hand, it just doesn't reflect real life, but we are going to do it and we are going to do it this way. How can GAAP be changed to make this more realistic or accurate?

Mr. LEV. That is really not a question that can be answered in a few minutes. This is a huge system that was somehow——

Mr. STEARNS. Let me just help you. Would you take GAAP and make it more like the European Union, principle based rather than law based.

Mr. LEV. Yes. I will definitely make it much simpler than it is now based on a few rules and objectives and supplement it with rather than instructing people exactly how to account for everything as I said before, which is basically self-defeating, I would supplement the relatively few rules and instructions with very detailed full disclosure, just tell the story and shift the emphasis to the full disclosure. If Freddie Mac would have fully disclosed these schemes, I have no doubt in my mind that they would not have entered into them in the first place if they knew that they had to fully disclose this. That they bought this and sold this and parked it 2 hours in between. Full disclosure which may take maybe 10, 15 more pages in the financial report, I think will do a lot of good.

The second thing that I do and this relates to the multitude of estimates and judgments that go into it, I would cut many of them because they don't serve any purpose and they open the door for the crooks. And I would and I already suggested it several times, I would distinguish in the financial reports between facts and estimates, or as some people say, facts and fictions in this case. You could have an income statement with rather than one column, you will have two columns in this case. One will be facts—facts are mostly cash-flow transactions. And then there are estimates.

So I don't throw all the estimates out, but readers have an idea about the vulnerability of the report, is it based—are earnings based on 20 percent of estimates, 50 percent estimates, 80 percent estimates? This I think will go a long way. But we also have to think about substantive changes in the whole process that leads to this mushrooming of rules and regulations.

Let me say one more thing, with your permission, because you mentioned at the end of your question about management didn't believe that GAAP in this case portrayed reality. And we heard it several times today that as opposed to Enron and others, they were understating income, not overstating income as if this is a mitigating factor. Now I, of course, don't know what the intention of the former management was. I never spoke with any of them. But I know from experience that most managers understate income in several periods because they know that they need these reversed to overstate income in the future.

This is the reason for understating income. It is a very sinister thing. And it is not somehow a good thing to understate income. By understating income, you create a reserve, 2 years, 3 years down the road when earnings are really low you say, we have a reserve and we can use it. And of course, Freddie Mac used reserves

in this case. So what they did was not something which is, in my opinion, somehow tame or even a good thing. It is no better than overstating in my opinion.

Mr. STEARNS. Ms. Schakowsky.

Ms. SCHAKOWSKY. Professor Lev, I agree with your assessment, but there have been times in the past when FASB tried to rebuild it in a way that created transparency standards for accounting of derivatives and it was met with strong opposition from powerful interest groups and Members of Congress and Federal Reserve Chairman Alan Greenspan. And as a result of the opposition, SFAS 133 includes over 700 pages of exemptions. Do you think FASB would encounter the same opposition if it tried to strengthen SFAS 133 and close the loopholes?

Mr. LEV. I really don't know. Perhaps. Whenever you hit vested interests, you encounter opposition. But I think if the major objective is toward implicit perhaps toward low burden, you will encounter less antagonism than they encounter now than just by piling up statement after statement and rules after rules.

Ms. SCHAKOWSKY. So the decrease in the burden of all the rules that exist right now might be incentive enough.

Mr. LEV. I don't advocate to throw out the rules now. You know this committee about a year ago, I suggested and the chairman mentioned it today to set up a blue ribbon committee because things are really involved in this case. Accounting is complex. Business becomes more and more complex. Crooks proliferate. So it is not an easy thing to do, you know, just to sit here and give a few suggestions. It has to be studied very carefully, but with an objective in mind. And in my mind, the main objective is simplify the system as much as you can.

Ms. SCHAKOWSKY. Let me just state two more questions I have. Mr. Doty, Professor Lev said that understating earnings was not benign at all and that this is a serious problem and that we should be concerned about. So that is one I want to ask. The other is because we are talking about Freddie Mac. We talked about its impact on capital markets, but is there something to worry about in terms of housing markets, too, because that is, after all, what its business is.

Mr. DOTY. Excellent questions. First, I don't think anyone should read the facts found about deferral of income as mitigating factors or as vindication or any of that nature. That does affect the quality of earnings. The missing piece here is that the SEC expects that companies will discuss their critical accounting policies, disclose transactions and accounting policies and estimates that affect the quality of earnings. And I think its very clear that we fault Freddie Mac for a failure to make transparency come about by explaining how these transactions—and in the CTUG transactions, same was true.

As to the tension between the housing markets, it is a point of pride with many at Freddie Mac that the retained portfolio grew because the company was buying mortgages and providing liquidity of that market at the time of the collapse of long-term capital management and during the international debt crisis. There is an issue for this honorable House and the Senate as to how you manage that, but it is part of your accounting, I think responsibilities here

and the concern you are showing for accounting rules that you consider that one size may not fit all and there may be questions of whether we want a system in which derivatives are counted for in one manner in all cases.

Do we want a system in which if—in which the most conservative accounting is always opted for. Do we want a system in which companies must include an operating earnings or a core earnings comparison along with a GAAP-reported comparison. There are many options before you and before FASB. And they are going to be worked out I think in the arena of international accounting standards and they will bear on how much latitude and how much color or texture we want public companies to give to financial presentations and how consistent is that with the rigor and the accuracy that we require of GAAP. And I do not believe that that is a question that is susceptible of a simple answer, but I think it is commendable.

Ms. SCHAKOWSKY. I would ask you to comment on this notion that true full disclosure would at the very least be very helpful, even if we don't throw out GAAP and move to principles, but this notion of much clearer disclosure and much more complete disclosure.

Mr. DOTY. I think that is what the public wants and I think that is what Professor Lev is alluding to. It has to do with the fact that the amount of detail and the length and complexity of notes I think is deterrent to some person's feeling when they are reading financial statements. The Commission has, in the adoption of management discussion and analysis, attempted to deal with that, but it seems to me the challenge is to create the understanding for what the accounting—what the audit represents and what can be expected of an audit and what the accounting principles really show without throwing out the level of detail and rigor that our current system provides. Thank you.

Mr. STEARNS. Thank my colleague, Mr. Shadegg.

Mr. SHADEGG. Thank you, Mr. Chairman. I want to compliment you on this panel. I think this has been one of the more informative discussions that I have heard in any congressional testimony and I compliment you all for a very elucidating discussion. Professor Lev, I have to tell you I absolutely loved your example. I am actually building a house right now and you are right. I don't know whether it meets the building codes. I want to know if it is built right, if it is sound and if it is going to stay up. And if the building code is defective and the engineer says to me that it meets the code but it is going to fall down next week because the code is defective, it doesn't mean a thing to me. So I loved that point.

The chairman has already asked the first question begged by your testimony, which is what can we do for GAAP? And you explained that is difficult to answer. Though I understand that as a general proposition, you would say eliminate some of the detail, move toward principles and guidelines requiring full disclosure and honest disclosure, and I gather more sunshine in terms of full reporting; is that correct?

Mr. LEV. Yeah. Definitely.

Mr. SHADEGG. I happen to be a lawyer and the code of ethics for lawyers is, in many ways, susceptible of criticism as being too

vague because it requires you to do the right thing. Then somebody gets the second guess whether it was the right thing. Yet, I think your point about complexity being a haven for crooks is well taken. The second question begged by your testimony is you said to strengthen the controls and transparency over Freddie Mac itself. Of those that have been discussed or of any others, do you have specific recommendations?

Mr. LEV. I really didn't investigate this issue carefully. People are saying maybe should move to Treasury, but that is not an area I feel competent.

Mr. SHADEGG. Okay, I understand that you don't have an opinion about that. Mr. Doty, I also appreciate your report and I think you have done a great service with it and with your testimony as well. Let me ask you, do you agree with Professor Lev with regard to the idea of simplifying GAAP and requiring it to be more principled-based? And if so, is that a feasible challenge.

Mr. DOTY. I believe we are speaking, Mr. Shadegg, of ideals that are very difficult to implement. And I think there would be harm to the system if we allowed rigor in the requirement of conservatism in the application of principles to be thrown over in order to get simplification. I don't understand Professor Lev to be advocating that at all. I do think we have a third factor pressing on this and that is international accounting standards, the listings that we want to retain in this country and the view of some European issuers that our accounting rules are already too burdensome. And when we talk about principle-based accounting we mean more lenient presentation of deferral of earnings or concealment of reserve policies. And then I realize no one on this panel and not Professor Lev is advocating that.

So it seems to me the devil is, as always, is going to be in the details, but that we should be able to accelerate the release of these standards so that they are more timely to create an overarching purpose for them that can be understood by laymen and others and to implement the accounting with more transparency in the contextual disclosure, and I think that will go a long way.

Mr. SHADEGG. If there were a patina over GAAP, which said that these rules apply to the extent that they fully disclose or more carefully, more accurately reflect the true condition of the company, would that be an improvement?

Mr. DOTY. I believe you have just described what would be set forth as being the guiding principle of GAAP plus. When all of these transactions were occurring, GAAP plus was not a household word. It has become a household word, and I think people want it, but I think what you are describing is intended to get us to GAAP plus. Show us what the rules provide as a picture of the company, but put in the context that avoids hiding behind the rules in order not to tell people what this means for the company's performance.

Mr. SHADEGG. I think you both clearly described that Freddie Mac took the specific rules and used them to conceal information rather than to disclose information that was important to investors and analysts and that put us in the box.

Professor Lev?

Mr. LEV. I think an example that will help here to clarify the point is differences between principles and rules. Let's take FASB

133, the financial instrument thing. You can state an objective, you can state the rules that financial instruments are assets and liabilities, they should be presented by the company at fair value or any other value, and then let the company report, let the auditors be responsible for the report, rather than the current situation in which, in addition to this, there are hundreds, sometimes thousands of pages prescribing specific instruction for everything, for every type of swap and for every type of option, for everything. That is what I think is not only redundant, it is even dangerous.

The reason, if I can say one more sentence?

Mr. SHADEGG. Sure.

Mr. LEV. The reason, we have to understand the reason.

The reason why it mushroomed in the United States more than other countries to this extent is that this is a litigious society. Both corporations and accountants come daily to the FASB and they said give us a rule. It is not that the FASB imposes rules. They ask for the rules, because they somehow feel safer with a rule than just in following or maybe not following the rule, as in this case, than if there is some kind of a gray area and they have to take responsibility.

This thing has to be resisted, in my opinion.

Mr. SHADEGG. Thank you very much.

Mr. STEARNS. I think we will take one more set of questions, Ms. DeGette, before we go.

Ms. DEGETTE. Thank you, Mr. Chairman, and I would like to welcome the panel and ask unanimous consent to put my opening statement in the record.

Mr. STEARNS. So ordered.

Ms. DEGETTE. Thank you, Mr. Chairman.

[The prepared statement of Hon. Diana DeGette follows:]

PREPARED STATEMENT OF HON. DIANA DEGETTE, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF COLORADO

Thank you, Mr. Chairman. Following the accounting scandals and subsequent investigations at Enron, WorldCom and Qwest, Congress passed important legislation in the form of the Sarbanes Oxley Act, which helped to increase the transparency in financial reporting and proved to be an important step in cracking down on the financial engineering within Corporate America. Unfortunately, the recent revelation that Freddie Mac distorted or "smoothed" its earnings and blatantly disregarded accounting rules in order to bring profits in line with Wall Street estimates, proves that more must be done. Indeed, the very fact that Freddie Mac—which is not only one of the largest financial institutions in the world, but also a *Government* sponsored entity has been employing the same sort of fraudulent accounting practices that Enron used, demonstrates how systemic these crooked financial engineering practices are.

A little more than 18 months ago, this sub-committee convened to discuss accounting reform as it related to, what at the time, was unfolding to be the Enron scandal. At that hearing, we highlighted that one of Enron's failings was the fact they engaged in highly volatile transactions without adequately disclosing the risk involved. Enron turned out to be a major dealer in derivatives and employed several engineering activities in order to keep their derivatives' losses off of their financial statements. Although this may be considered the most innocuous of Enron's violations, it nevertheless brought into question whether there needs to be stricter accounting regulation regarding derivatives.

Freddie Mac, while certainly no Enron, nevertheless employed similar strategies in order to avoid stating the accurate market value of their derivatives portfolio. In fact, in June 2001, Freddie Mac engaged in several, extremely complex transactions in order to avoid realizing a non-recurring gain of \$1.4Bn from its hedging portfolio.

While unlike in the cases of Enron and Worldcom, Freddie Mac *understated* earnings in June 2001, instead of *overstated* them, the aim was nevertheless the same:

to manipulate profits to bring them in line with Wall Street expectations. However, by avoiding a large one-time gain in June 2001, the Company was able to bleed in the extra earnings over the next two years, overstating their profits during this time period. In addition, Freddie Mac's management further manipulated profits by artificially stating the value of various reserve accounts.

In the end, the effect was that Freddie Mac reversed engineered their earnings to coincide with Wall Street's expectations—a steady, but northern moving bottom line. And once again, in the end, the end consumer, in this case the investor, turns out to be the biggest victim. It is the public who lose out from the lack of transparency and from the gross disregard of accepted accounting principles—not only financially do the consumers lose, but once again their trust in a system that is supposed to contain safeguards to protect them has once again been rocked.

Of course, the blatant disregard for accounting rules exhibited by Freddie Mac simply did not happen in isolation—it entailed cooperation on many levels: from the management team to Freddie Mac's internal corporate accountants to the Company's external accounting firm, Arthur Andersen. Though it would be easy to presume that the shady accounting practices at Freddie Mac have been eradicated with the ousting of key members of the management team and the dissolution of Arthur Andersen, it is nevertheless incumbent upon us to ensure that that we not only trim the weed of a culture that embraces accounting negligence, but pull it up from its very roots.

What potentially may be even more disturbing than Freddie Mac's blatant manipulation of GAAP and consequent lying to investors, is that if the Company had structured their transactions more cleverly, they could have still adhered to GAAP while keeping the fair value of their hedge portfolio off of the books. Is it possible that even after our dealings with Enron that we support an accounting system that is so vulnerable so as to actually invite manipulation? Hopefully, this hearing will bring us one step closer to understanding—and making—the necessary reforms that must be made in the accounting system.

At one point, I was under the impression that accounting was a cut-and-dry practice—similar to math in the sense that there was one right answer. More and more, however, I realize that many corporations treat accounting less like a science and more like art—open to creative interpretation and manipulation. We must not allow companies to employ fuzzy math or artful accounting in order to line their own pockets.

It is imperative that we do what is in our power to streamline and correct our current accounting system so that the accounting practices at the Enrons and the WorldComs—and I am disheartened to say it, at the Freddie Macs of this world, do not happen again.

Ms. DEGETTE. Mr. Doty, as I understand it, Freddie Mac manipulated its earnings for 11 consecutive quarters by engaging in complex derivative transactions and by artificially stating the reserve accounts, which were in blatant disregard of SFAS 91. Is that an accurate statement?

Mr. DOTY. It is certainly a statement that some may make. They—

Ms. DEGETTE. Do you think it is inaccurate?

Mr. DOTY. They achieved—lawyers are prone to take striking statements and reduce them to more banal statements, I guess.

We see it—

Ms. DEGETTE. Some lawyers at least.

Mr. DOTY. Well, the fact is that they did concoct capital market transactions in order to defer earnings and to mitigate volatility. The means whereby they fine-tuned the earnings to achieve the analyst expectation within two or three cents a share was largely the reserve accounting in a few selected reserve funds.

Ms. DEGETTE. And they did this for 11 quarters, right?

Mr. DOTY. They did it and their auditors knew—

Ms. DEGETTE. For 11 quarters?

Mr. DOTY. Yes, and with full knowledge.

Ms. DEGETTE. So you wouldn't really disagree with this statement?

Mr. DOTY. Well, I think we come down hard on the practice.

Ms. DEGETTE. Okay. Well, in your report you say these systematic efforts to change earnings to meet Wall Street's expectations were a blunder, right?

Mr. DOTY. No.

Ms. DEGETTE. No?

Mr. DOTY. We say that in many of the derivative transactions they involve the unintentional misapplication of GAAP, a clear misapplication of GAAP.

Ms. DEGETTE. Do you think it was intentional or unintentional?

Mr. DOTY. We believe that they thought they were complying with GAAP. This is what a GAAP centric rules-based system can produce.

Ms. DEGETTE. Professor Lev, do you believe that? Do you believe they were complying with GAAP?

Mr. LEV. I really cannot read the minds of these people.

Ms. DEGETTE. Sure.

Mr. LEV. I didn't speak with them. I don't believe such elaborate schemes over extended periods will be benign.

Ms. DEGETTE. See, I am also on the Oversight and Investigations Subcommittee and we were the ones that did the investigation into WorldCom and Enron and all of those evildoers, and they all said the same thing. They all said, well, we thought we were complying with the accounting standards when we concocted these elaborate transactions, and I guess in my mind, as a lawyer, when I see somebody over 11 consecutive quarters making these very elaborate—constructing these very elaborate transactions, I can only come to the conclusions that they are using GAAP as a kind of mantle to shield their actions.

Now, Professor Lev, you are nodding, I hope, in agreement.

Mr. LEV. In principle, I agree with you, yeah.

Ms. DEGETTE. Something else, I don't have much time left, and we have a vote on the floor. One of the issues that came out of the corporate responsibility hearings that we had was the issue of board accountability, and several of you have mentioned the concept of trying to have people have a conservative interpretation of GAAP. I am wondering, Mr. Doty, in your report, you said that the Board was aware of this "Steady Freddie" mentality, but because the flow of information was so limited the Board did not fully understand what it complied.

Do you believe that Freddie Mac's board from 2000 to 2002 neglected their fiduciary duty to protect shareholders by not probing even more deeply into how this goal was being achieved?

Mr. DOTY. No, Congressman. I am burdened by the knowledge that they tried very hard at the end of 2000, going into 2001 and through 2001, to achieve greater control of the accounting function. This was a very proactive board. It has been extremely proactive since January, 2000.

Ms. DEGETTE. I bet they have.

Mr. DOTY. But at that time, at the time you are inquiring of, they were expressing grave discontent with management for having people in corporate accounting who they thought were not up to the task.

Ms. DEGETTE. Well, if I could interrupt you.

Mr. DOTY. They were overseeing, they were not managing.

Ms. DEGETTE. We had the same problem, too, where the Board was saying we have grave concerns but at the same time these practices were going on.

I wonder if you have any thoughts as to how we can beef up information or the Board's oversight responsibility so that these practices don't continue to go on, even when board members are expressing concern.

Mr. DOTY. Well, I think you can look at what board members do. Board members are going to be judged by the courts and by the regulatory agencies as to whether they are actually going to be doing things that deal with these problems. I think in the case of the Freddie Mac board it will be seen that they did. They were seeking to recruit and to obtain a chief financial accounting officer who had real expertise. They were thwarted in that goal. They sought to do something about errors in the accounting that they began to perceive at the end of 2001. They were thwarted. They called in management in the spring of 2002 and said, unless you fix these problems immediately your pay is going to suffer. It is probably the most immediate control a board of directors has over management is to threaten their pay and the Freddie Mac board was a bit ahead of their time in doing it.

Ms. DEGETTE. Thank you.

Mr. STEARNS. I thank my colleague.

We are going to take a temporary recess. We appreciate your patience. We are going to go take a vote and then we will reconvene.
[Brief recess.]

Mr. STEARNS. The subcommittee will come to order.

Mr. Barratt, we want to get you involved here, so we have got some questions for you. Explain to us why companies would want to change the characterization of assets from "held to maturity" to "available for sale," and what are the implications for these changes, and keep it simple for all of us, for sixth graders.

Mr. BARRATT. I will try. I think one way I think of it is you have kind of three buckets, you have held to maturity, you have available for sale, and then you have trading, and depending on which classification you get in, you get different accounting treatment. So in this case held to maturity is carried on the books at amortized cost. It is not subject to the fluctuations and market. It is not market to market, but the person who makes the decision of what goes in each bucket, people could make different decisions on what goes in the bucket, right?

Mr. STEARNS. Yes.

Mr. BARRATT. And there is another, FASB 115, that goes to that classification. You have held to maturity, the literature says there is a positive intent and the ability to hold it to maturity. So there is a desire instead of just classifying it 1 day one way and then another—

Mr. STEARNS. So it is pretty subjective?

Mr. BARRATT. Yes, and you can change it. Depending on a variety of circumstances, you may want to move it, but there is different treatment depending on what bucket you are in.

Mr. STEARNS. Hmm.

Mr. BARRATT. And available for sale when they mark to market, that adjustment goes through the equity part of the balance sheet, so there is not an income statement effect when there is changes available for sale.

However, on trading, when it is mark to market, it hits the income statement and does affect your earnings and volatility.

Mr. STEARNS. Does FASB clearly point out what the requirements are in determining what goes in, for example, each of these buckets, and so forth?

Mr. BARRATT. I think——

Mr. STEARNS. Or is it just all subjective?

Mr. BARRATT. SFAS 115 does a pretty good job in saying what it takes to go into each bucket.

Mr. STEARNS. Okay. So should the characterization of an asset determine its accounting treatment?

Let me say that again: Should the characterization of an asset determine its accounting treatment?

Mr. BARRATT. I guess the example to answer that, if you didn't characterize these assets in one of these buckets or not?

Mr. STEARNS. Right.

Mr. BARRATT. That could create problems that you are alluding to, that you could kind of move things around for your own purposes, so I think it is important that there is some characterization and make them accountable to what the intent is with regard to the securities.

Mr. STEARNS. Explain to us on the basis of your work some of the steps companies take to avoid fair value accounting of derivatives?

Mr. BARRATT. Avoid fair value.

I guess to kind of mitigate the effect of the fair value in recognizing these gains there is a variety of things. In this case, for example, there is the swaption valuation change where you just have a different valuation model to avoid some of that gain that comes from fair value.

Another thing you can do is there is derivatives that are not in a hedging relationship, are mark to market, through earnings, and they affect the income statement. So to the extent you can pair up those non-hedge derivatives in a hedging relationship, you can avoid that income hit from fair value accounting.

Mr. STEARNS. Do you think that these actions to avoid fair value accounting are socially useful? You might have to take off your forensic and litigation advisory cap to do this.

Mr. BARRATT. Mr. Doty may have an opinion on this.

Mr. DOTY. Socially useful.

I think, just to step back, I think SFAS 133, in its intention to have fair value accounting, instead of just having historical costs that might be on there or not even the balance sheet, it is a good thing to have more relevant, more timely information available to investors. So I think it is a desirable objective, but I think, as we have learned today, that the rules that set out how you do that create some difficulty sometimes in achieving it.

Mr. STEARNS. So your answer to socially useful is, what, yes or no?

Mr. DOTY. Well, to avoid fair value accounting I would say is not socially useful.

Mr. STEARNS. Okay. Just for my colleagues and perhaps for the panel, I asked to get the book on this FASB Statement 133, and this is it, and, you know, there is a lot of appendix here, but you can see that accounting for derivative instruments and hedging activities, this is the kind of document that people must understand, comply with, and this one they try to manipulate. They have got to understand how to manipulate, and there are things like how should the basis of a hybrid instrument be allocated to the host contract in the embedded derivative when separate accounting for the embedded derivative is required by Statement 133. So the people who are involved here are obviously pretty smart and knowledgeable to be able to even get to the starting line in this thing. So these are not people that are going to blunder so much as I think work the system here, and for good or for bad, the GAAP is allowing it.

So that is my 5 minutes.

Ms. McCarthy, would you like—

Ms. MCCARTHY. Mr. Chairman, thank you both for this hearing and thank the witnesses for sharing their expertise with us.

The SEC report required by Sarbanes-Oxley concluded that the principle only standards present enforcement difficulty. I know you are aware of that. We have all seen issues and discussion of that in the press, but they are concerned because they provide little guidance or structure for exercising that judgment by preparers and auditors, and this is of concern to me and I am sure other members of the committee. They recommended something else they called principle-based or objective-oriented standards which possess the following characteristics, and I will share them with you, although I am sure you are familiar with them, that they be based on an approved and consistently applied conceptual framework, clearly state the accounting objective of the standard, provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis, minimize exceptions from the standard and avoid use of percentage tests, bright lines, that allow financial engineers to achieve technical compliance with the standards while evading the intent of the standards, and I wondered, Professor Lev and Mr. Doty, if you would support such a solution.

Professor Lev and then Mr. Doty.

Mr. LEV. Let me just say that I am not a great fan, personally, of principles versus rules, particularly because I don't know when a principle ends and the rules starts. I mean, the thing is extremely vague.

What I was proposing, and it is in line with what you just read, is really simplification, focus on a few governing objectives. You can call them principles. Definitely avoid, and I must say the ridiculous thing that was just quoted by the chairman from FASB 133, which is so incredibly detailed, dealing with an instrument that maybe even doesn't exist anymore right now, because things change very quickly, and then putting emphasis, as I said before, on full disclosure. I heard someone saying here during the intermission that no

one reads financial reports, and they definitely won't read the full disclosure.

This is absolutely wrong. My daughter is a financial analyst. She reads financial reports of the companies that she follows, every single word, and what she doesn't understand she pesters management in conference calls about that, so I don't care whether 95 percent of investors don't read financial reports.

Those that read determine the price and the volume, so I just refuse to accept that the only way to go is just making the system like the book that the chairman is now holding, which is only the rules. Then you have thousands of pages of interpretations that follow this thing.

Ms. MCCARTHY. I thank you, Professor, and I do agree that rule based standards only provide that vehicle for circumventing the very intention of the standard that we want to have met.

Mr. Doty.

Mr. DOTY. Well, I think one comes away from this experience believing there is no substitute for good judgment properly applied.

One of the things, one of the transactions for which we fault Freddie Mac was the employment of an account, a reserve account, with the full knowledge of their independent auditors, their independent auditors, which was not maintained consistently with GAAP, and they knew it was a non-GAAP account but it was allowed to be used for this purpose of earnings smoothing because the amounts were not material. So it is an example of what you were pointing to, Ms. McCarthy, of the use of a quantitative test in a context in which the judgment should have been quite different from the quantitative test, and it is clearly the case that professionals have a duty, we do, as lawyers, accountants have, to use judgment.

It seems to me that there is an historical sea change at work, a cultures change within professions, and what we are seeing now at Freddie Mac as they labor through their restatement is the adoption of a new corporate culture that is quite different from the one obtained before, and we would hope and I think we would expect it is going to be much more laden with correct judgment.

Ms. MCCARTHY. Thank you very much for your answers and thank you, Mr. Chairman. I yield back.

Mr. STEARNS. I thank the gentlelady. I think we are ready to conclude. Mr. Doty, I just have a few items.

Who were the counterparties in the Giant and the J deals? Can you specifically tell us who they were?

Mr. DOTY. I can. We have not made a great deal of this in the report because the transactions were initiated by Freddie Mac, but Salomon Smith Barney was a counterparty chosen in the Cetaug transaction and Morgan Stanley in the J deals.

Mr. STEARNS. It was just those two then?

Mr. DOTY. Yes.

Mr. STEARNS. Professor Lev, you have pointed out the two major problems with GAAP, extreme complexity and vulnerability to manipulation.

I asked in my first series of questions what should be done. I guess now I am asking you the problems of earning management

is widespread. I think that is what you are indicating in your testimony.

Could you take another shot at what should be done and maybe I will ask the other folks too, and that will be our conclusion here.

Mr. LEV. In the case of earnings management?

Mr. STEARNS. Yeah.

Mr. LEV. I mean, in addition to all the things that——

Mr. STEARNS. Or is it benign?

Mr. LEV. It is definitely not benign.

Mr. STEARNS. Okay.

Mr. LEV. It is not benign because it affects market prices and the decisions of people.

I mean, in addition to all the things, you know, strengthening the board and auditors and so on and so on, it also behooves some in the investment community to do something. They basically perpetrate the whole thing. Their complete focus on quarterly earnings of companies motivate this kind of an earnings game, a much more reasonable focus, rather than on quarterly earnings. If you think about earnings of a company, quarterly earnings are almost completely meaningless. They are largely effected by random things, transitory things.

If they would have focused more on long-term measures, like three quarters, four quarters, and so on and so on, the whole game would lose much of its power. Some leading companies—I don't see it mushrooming, but there was a beginning. Some leading companies announce in the wake of all the scandals, announce we are not going to give any guidance about earnings or they took themselves out of the earnings game.

I think only giant companies can afford at least at the beginning to do such things, but this is really a difficult issue. It is so endemic to the investment process, this focus on everything short-term.

Mr. STEARNS. Mr. Barratt.

Mr. BARRATT. My only thoughts there would be I think in some cases adjustments were considered to be immaterial. They were so small that either the auditor or the company didn't necessarily consider it possibly the way they should.

I think Staff Accounting Bulletin 99 that SEC issued has got some way to address that, and so the other point I would make is I think now, in light of all, Sarbanes-Oxley and everything else that is going on, I think auditors in companies will be looking at all the adjustments that were going on, that were either proposed, or not made and really I think drilled down to the point where it is more difficult possibly to——

Mr. STEARNS. To do it.

Mr. BARRATT. To achieve that, yeah.

Mr. STEARNS. Mr. Doty.

Mr. DOTY. Three things, disclosure, better disclosure, and the best disclosure, and I think if you do that I know of no area in our national life in which disclosure hasn't cured a great many problems.

Mr. STEARNS. Just bring some sunshine in?

Mr. DOTY. Yes.

Mr. STEARNS. Let me thank all of you for your testimony and thank you for your patience and indulgence while we voted and also thank Freddie Mac for their cooperation and directness here. It has helped and I think jurisdiction of our committee is such that we are trying to work on some kind of legislative initiative here, dealing with FASB, and I think you have been very helpful, and with that, the subcommittee is adjourned.

[Whereupon, at 11:50 a.m., the subcommittee was adjourned.]

